

Letter of Findings: 04-20110122
Sales and Use Tax
For the Year 2007

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ISSUE

I. Sales and Use Tax – Industrial Production Exemptions.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; IC § 6-2.5-4-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1(c); See *Rhoades v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Rotation Products Corp. v. Indiana Dep't of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998); *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Indianapolis Fruit Co. v. Department of State Revenue*, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); *N. Cent. Indus., Inc. v. Indiana Dep't of Revenue*, 790 N.E.2d 198 (Ind. Tax Ct. 2003); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-10](#).

Taxpayer argues that its purchases (or in one case, rental) of equipment, tools, supplies, and utilities were not subject to sales or use tax on the ground that they qualified for various industrial production exemptions.

STATEMENT OF FACTS

Taxpayer is an Indiana S corporation that processes and sells various limestone products such as agricultural lime, crushed stone, gravel, rip rap, top soil, and fill dirt. For the years at issue, Taxpayer bought overburden limestone from an unrelated quarry.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the year 2007 which resulted in an assessment of additional sales and use tax.

Taxpayer disagreed with the assessment and submitted a protest to that effect. The items Taxpayer is protesting include equipment, tools, supplies and utilities it purchased to perform activities it considered to be exempt from sales or use tax because they qualified for the industrial production exemptions. An administrative hearing was conducted and this Letter of Findings results. Additional information will be provided as needed.

I. Sales and Use Tax – Industrial Production Exemptions.

DISCUSSION

The taxability of all of the protested transactions rests on whether Taxpayer's process qualifies for the industrial production exemptions.

The Department concluded that Taxpayer's process did not qualify for the industrial production exemptions because Taxpayer did not substantially change the raw material and therefore Taxpayer had purchased non-exempt tangible personal property for which it had failed to pay sales tax and for which Taxpayer had not remitted use tax.

Taxpayer, on the other hand, argues that it qualifies for the industrial production exemptions for several reasons, including that the limestone slabs have limited or no economic use before they are crushed, that there is significant change in the size and character of the limestone slabs and that multiple types of product result from Taxpayer's process (agricultural lime, crushed stone, gravel, rip rap and top soil). In a letter dated February 25, 2011, Taxpayer describes its operation as follows:

The taxpayer operated a stone crusher at his business location [] during the audit year of 2007. The crusher processed "raw" limestone delivered (purchased) from a nearby quarry (unrelated entity) to produce various sized crushed stone materials that was then sold to customers. The actual process consisted of large pieces of limestone (up to 3ft x 3ft x 3ft in size) being placed into the hopper which was the starting point of the crushing process. From there, the stone was then crushed into much smaller crushed stone products which could then be sold to customers for various economic uses. Depending on the settings for a particular run, the stone could even be reduced to lime dust. Once the stone was crushed it was then conveyed across one of the various conveyor belts and accumulated into piles at the end of the conveyor. For some of the products, this was the final step in the manufacturing process and from this point the finished product was moved by a loader to its respective stockpile to be available for sale to customers. However, some of the products required a further processing step after coming off the conveyor. This process, referred to as blending, was required in order for the final product to meet certain specifications as required by some customer orders. The blending process involved the use of a loader to take the applicable materials piled at the end of the conveyors and turn/mix it until the desired "consistency" was achieved. The blended product was then tested through labs to ensure compliance with the required specifications. If the testing showed that the required specifications had not been met, then further blending and restating was required. Once the

testing confirmed the product met the required specifications the product was then considered a finished product and stockpiled and made available for sale to the customer.

Taxpayer is protesting the assessment of tax on transactions relating to a crusher and one or more loaders used by Taxpayer in its operations. Taxpayer is also protesting equipment, tools and supplies relating to the crusher and loader(s). Taxpayer argues that the crusher and the items relating to the crusher are 100 percent exempt because they are subject to the industrial production exemptions. Taxpayer states that the loaders it is protesting are used in both exempt and non-exempt activities. Taxpayer states that the loader is being used in exempt fashion when it is "blending" aggregate and when it is being used to maintain the conveyor belts (see Taxpayer's above description of its protest), which add up to thirty-percent of its use. Therefore, Taxpayer requests thirty-percent exemption on the loader(s) and related equipment, tools and supplies.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See *Rhoads v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions that escape sales tax liability are nevertheless taxed. *Id.*; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 468-69 (Ind. Tax Ct. 1993). To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. *Id.*

An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax some of which are collectively known as the industrial production exemptions. *Rotation Products Corp. v. Dep't of State Revenue*, 690 N.E.2d 795, 798 (Ind. Tax Ct. 1998). A taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) *aff'd* 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). A statute which provides a tax exemption is strictly construed against the taxpayer. *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 100-01. Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." *Id.*

There are several relevant industrial production exemption statutes in this instance. IC § 6-2.5-5-3 states the exemption for tangible personal property acquired for direct use in direct production:

(a) For purposes of this section:

(1) the retreading of tires shall be treated as the processing of tangible personal property; and

(2) commercial printing shall be treated as the production and manufacture of tangible personal property.

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

IC § 6-2.5-5-4 states the exemption of tangible personal property acquired for use in producing machinery, tools, or equipment directly used in direct production:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

IC § 6-2.5-5-5.1 states the exemption, for the year at issue, of tangible personal property acquired for direct consumption in direct production:

(a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.

(b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

In reviewing the "production" exemption statutes, the Tax Court has explained that, "All [] exemption provisions require that the taxpayer engage in production before qualifying for the exemption" and that "[p]roduction does not have different meanings under different exemption provisions." *Indianapolis Fruit Co. v.*

Department of State Revenue, 691 N.E.2d 1379, 1383 (Ind. Tax Ct. 1998).

The Department's regulations offer some guidance in determining what qualifies as an exempt production process. [45 IAC 2.2-5-8](#)(k) states:

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

(Emphasis added).

Also, [45 IAC 2.2-5-10](#)(k) states:

Definitions. Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change.

Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

(Emphasis added).

Taxpayer argues that its products are substantially changed from the limestone slabs that it receives.

Taxpayer argues that the limestone slabs have limited or no economic use before they are crushed, that there is significant change in the size and character of the limestone slabs and that multiple types of product result from Taxpayer's process. Therefore, the issue is whether the commodities or products which Taxpayer sells to its customers have undergone a "substantial" change in form, composition, and/or character.

[45 IAC 2.2-5-10](#)(k) provides:

Processing... is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired.

The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing... although any operation which has such a result may be processing.... A processed... end product, however, must be substantially different from the component materials used. (Emphasis added).

As the Tax Court has explained, Whether or not a change is "substantial" depends on, among other factors, the complexity of the activity undertaken by the processor, the addition of new parts by the processor, and the difference between the end result and the initial components. See *N. Cent. Indus. v. Dep't of Revenue*, 790 N.E.2d 198, 201-02 (Ind. Tax Ct. 2003). Taxpayer argues that its products are substantially changed from the raw material that it receives, the limestone slab.

The Tax Court's decision in *Rotation Products* is instructive on the question of whether or not a commodity has undergone a "substantial change." In that case, the court set out a four-part test to determine whether or not the petitioner was in the business of "manufacturing" as follows:

The case law reveals three factors germane to this fact-sensitive inquiry. The first is an adaptation of the requirement of a substantially different end product: the substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts. The other two factors derive from the observations of the courts dealing with this issue: a comparison of the article's value before and after the work, and how favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind. Additionally, this Court concludes that another factor is applicable to this inquiry: whether the work performed was contemplated as a normal part of the life cycle of the existing article. This additional factor will prevent work that merely perpetuates existing products from qualifying for an industrial exemption. *Rotation Products*, 690 N.E.2d at 802-03.

In a setting such as Taxpayer's, for purposes of determining whether a taxpayer's "products are [substantially] different and distinct from the raw materials purchased...." the Department concludes that a consideration of several factors is appropriate. None of these factors is necessarily dispositive of the matter, but individually or collectively may lead to a reasonable conclusion that the taxpayer is or is not entitled to the exemption. These factors include, in no order of priority, the nature of the items produced, the complexity of a taxpayer's process, the creation of a marketable product, physical and/or chemical changes that occur to the raw materials, the complexity of the resulting products, and the transformation of the raw materials from items of no or little value to some value.

The process of producing Taxpayer's products is not complex. The limestone slabs are either broken up or crushed. Some of the products are tested to make sure they are appropriate for customer use. No other components are added to the single source products. However, the limestone slab clearly undergoes a physical

change that results in products substantially different in character from the raw material and from each other. According to the Department's audit, Taxpayer's products are sold in the marketplace. Taxpayer has transformed overburden limestone slab with little or no value into particular stand-alone commodities of value. Weighing these factors, the Department is prepared to agree that Taxpayer's process qualified for the industrial production exemptions.

However, the industrial exemption statutes, as explained by [45 IAC 2.2-5-8](#) allow the taxpayer to purchase machinery, tools, and equipment without payment of the gross retail tax when the equipment is used directly in the direct production of tangible personal property. [45 IAC 2.2-5-8\(a\)](#) specifies that the exemption is limited to that equipment "used by the purchaser in direct production." [45 IAC 2.2-5-8\(c\)](#) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." Refining the definition one step further, the regulation states that "[p]roperty has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property." *Id.* See IC § 6-2.5-5-3(b).

[45 IAC 2.2-5-8\(d\)](#) excludes pre-production and post-production activities by providing that "'direct use in the production process' begins at the point of first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its complete form."

Therefore, based on all of the above and on Taxpayer's description of its process, Taxpayer's exempt process begins with the placement of materials into the crusher and ends with the various processed products that come out of the crusher. Therefore, items relating to the crusher qualify for exemption.

As for the loaders, Taxpayer states that they are used in both exempt and non-exempt activities. Taxpayer states that the loader is being used in exempt fashion when it is blending aggregate and when it is being used to maintain the conveyor belts (see Taxpayer's above description of its protest), which add up to thirty-percent of its use. Therefore, Taxpayer requests thirty-percent exemption on the loader(s) and related equipment, tools and supplies.

The Department cannot agree that the loaders and related items are exempt. As described by Taxpayer, the "blending" process merely mixes already formed aggregate. This is a post-production activity as the aggregate has been formed. Neither the loaders nor the conveyor belts are exempt; nor are any items related to the loaders and/or conveyor belts exempt.

A supplemental audit will review Taxpayer's protested items and exempt the crusher and related items from sales and use tax. All other protested items remain subject to sales and use tax.

FINDING

Taxpayer's protest is partially sustained and partially denied.

A supplemental audit will review Taxpayer's protested items and exempt the crusher and related items from sales and use tax. All other protested items remain subject to sales and use tax.

Posted: 06/27/2012 by Legislative Services Agency
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